



BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

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In the Matter of the Application of
California American Water Company
(U 210 W) for a Certificate of Public
Convenience and Necessity to Construct
and Operate its Coastal Water Project to
Resolve the Long-Term Water Supply
Deficit in its Monterey District and to
Recover All Present and Future Costs in
Connection There with in Rates.

A.04-09-019

**REPLY BRIEF OF THE DIVISION OF RATEPAYER ADVOCATES ON
CALIFORNIA AMERICAN WATER COMPANY'S
REQUEST FOR INTERIM RATE RELIEF**

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Pursuant to Rule 13.11 of the California Public Utilities Commission's ("Commission") Rules of Practice and Procedure and the schedule set by Administrative Law Judge ("ALJ") Bertram Patrick, the Division of Ratepayer Advocates ("DRA") respectfully submits its Reply Brief in the above captioned proceeding. DRA's Reply Brief responds to the *Opening Brief of California-American Water Company ("Cal-Am") on Interim Rates*.

**I. SOME LIMITED INTERIM RATE RELIEF APPEARS TO BE
NECESSARY DUE TO THE EXTRAORDINARY NATURE OF
THIS PROJECT**

DRA and Cal Am agree that if the Coastal Water Project, as proposed, is approved by all permitting agencies and eventually built, it will be a unique and expensive facility. DRA and Cal Am also agree that the extraordinary nature and cost of the project requires some departure from traditional ratemaking principles. DRA and Cal Am, however, do not agree on the degree of departure necessary, the timing of the relief, and the structure of any authorized surcharges.

Below is a brief summary of these differences. DRA refers to its Opening Brief for a more detailed discussion of these differences.

A. Surcharge #1

DRA agrees with Cal Am that the Commission should authorize Cal Am to implement a surcharge to recover preconstruction costs as a direct reimbursement of the expenses. However, DRA disagrees with Cal Am's proposal to impose a surcharge to recover preconstruction costs before the Commission has issued a Certificate of Public Convenience and Necessity ("CPCN") for the project and before the costs have been reviewed for reasonableness. Much about the Coastal Water Project remains uncertain. The project is behind schedule, Cal Am has not secured a site for the plant, the local community is still pursuing a regional, publicly owned facility, and there is still strong local opposition to the project. (See DRA Opening Brief, pp. 8-11).

As discussed in DRA's Opening Brief, Cal Am's preconstruction cost must be reviewed for reasonableness prior to allowing recovery. Although Cal Am claims that an expert in the area of desalination and aquifer storage and recovery ("ASR") is not needed to review engineering and environmental costs incurred through 2005 and preconstruction costs incurred thereafter for reasonableness, DRA disagrees. DRA's Opening Brief discusses why such an expert is necessary. (*Id.* at p. 14-16.)

Cal Am believes that it should be allowed it to earn its authorized rate of return on preconstruction costs. DRA disagrees. The interest rate that Cal Am should earn on preconstruction costs should remain set at the 90-day commercial paper rate as authorized by the Commission in D.03-09-022. (Re California-American Water Company, D.03-09-022, p. 22.)

Finally, Cal Am recommends that the surcharge be structured as a percentage of the customers' bill. DRA disagrees. DRA recommends that the Commission structure the surcharge as a volumetric charge so that customers pay in direct proportion to their water usage. (DRA Opening Brief, pp. 40-41.)

B. Surcharge #2

DRA agrees with Cal Am that the Commission should authorize Cal Am to implement a second surcharge to collect funds to offset Coastal Water Project construction costs and to treat these funds as a "customer contribution." DRA and Cal

Am disagree about many details of this surcharge including when the surcharge should begin, how the surcharge should be structured, and the safeguards necessary to protect ratepayers. (See DRA Opening Brief, pp 31-40.)

DRA opposes Cal Am's request to begin surcharge 2 in January 2007. As discussed in its Opening Brief, the Commission should not allow Cal Am to implement surcharge 2 until the Coastal Water Project is permitted and construction has begun. The Commission should limit the amount that ratepayers contribute to ten percent of Cal Am's authorized revenue requirement for the year. (Exhibit 18, p. 30.) Like surcharge 1, the Commission should structure surcharge 2 as a volumetric charge so that higher water users contribute more to the project.

DRA's testimony and DRA's Opening Brief outline safeguards the Commission must adopt if it departs from traditional ratemaking practices and adopts surcharge 2 to pre-collect funds for this project. (Exhibit 18, pp. 30-31; DRA Opening Brief, pp. 36-40.)

II. CAL AM'S PROPOSAL IS NOT BEST FOR RATEPAYERS

Cal Am argues in its Opening Brief that its proposal to immediately implement two surcharges--which DRA has shown will result in a doubling of rates in just two and a half years and which shifts significant risk of project abandonment from shareholders to ratepayers-- is best for the ratepayers. DRA disagrees.

Adopting a proposal that doubles customers' rates in two years does not ease ratepayers' burden as Cal Am claims. When considered with rate increases that will likely result from Cal Am's general rate case, Cal Am's proposal results in three separate rate increases in 2007 and three separate rate increases in 2008. Subjecting Cal Am's ratepayers to six rate increases in two years that cumulatively double their bills is not a gradual rate increase. The company is also expected to file its next general rate case for the Monterey district in 2008, where the company will likely seek further increases in rates associated with its water operations.

DRA's proposal would gradually raise customers' rates to pay for the Coastal Water Project once there is some certainty that the project will, in fact, be built. In

addition, DRA's proposal provides ratepayers with protections against plant abandonment, imprudent expenditures, and paying twice for the project if it is sold to a public agency. (See DRA Opening Brief, pp. 8, 11-16, 34-40.)

III. CAL AM'S PROPOSAL IS NOT CONSISTENT WITH COMMISSION POLICY, PRECEDENT, AND PRACTICE

Cal Am claims that its proposed surcharges and outreach expenditure levels are consistent with Commission policy, precedent, and practice. (Cal Am Opening Brief, pp. 8, 23.) DRA disagrees. As DRA discussed in its Opening Brief, Cal Am's surcharge proposals depart from traditional ratemaking principles. (DRA Opening Brief, pp. 8, 11-12, 30-33.) The Commission recently stated that allowing a utility to recover costs for a capital project before it is used and useful was "without precedent." (Re Southern California Edison, D.05-12-040, p. 54.) Given the numerous uncertainties that continue to surround the Coastal Water Project, adopting Cal Am's ratemaking proposals at this time would be imprudent.

DRA will not reargue these issues here but refers to its Opening Brief for further discussion of how Cal Am's proposal departs from Commission precedent and practice. DRA here discusses those areas of Cal Am's Opening Brief that were not specifically addressed in DRA's Opening Brief.

A. Cal Am's proposal to spend \$35 per person on Coastal Water Project outreach is not in-line with expenses the Commission has allowed for conservation outreach

Cal Am claims that spending \$35 dollars per customer on outreach for the Coastal Water project is in-line with expenses the Commission has allowed Cal Am to recover for conservation outreach. (Cal Am Opening Brief, p. 23.) Cal Am claims that the Commission had authorized Cal Am to spend \$10 a year per customer on conservation and at least \$9 of this was spent on public outreach. (Cal Am/Tilden, 4 RT 333.) DRA disagrees.

As Ms. Brooks testified, the Commission did not authorize Cal Am to spend anywhere near \$9 per customer on conservation outreach. (DRA/Brooks, 6 RT 689-691.)

In Decision 03-02-030, the Commission authorized Cal Am to recover \$330,000 annually for conservation expenses. However, the Commission only authorized Cal Am to spend \$110,000 for notices and advertising. The remaining \$220,000 was authorized for various conservation programs. Specifically, the Commission authorized conservation spending for:

Conservation Expense Item	Adopted Amount
Advertising	\$ 50,000
Customer Notices	\$ 60,000
Outside Water Auditor	\$ 30,000
Miscellaneous Programs	\$ 40,000
Water Saving Device Rebates	\$150,000
Total	\$330,000

(Decision 03-02-030, p. 45)

DRA's witness, Brooks noted that using the \$110,000 or \$2.98 per customer the Commission authorized Cal Am to spend on conservation outreach is not a good comparison for what the Commission should allow Cal Am to recover for the Coastal Water Project outreach campaign. Conservation in Monterey is a crucial matter because Cal Am is subject to fines if it exceeds the production limits set by State Water Resource Control Board Order 95-10, which limits the amount of water Cal Am can take from the Carmel River. (DRA/Brooks, 6 RT 690-691.) Educating customers about desalination technology¹ is far less important than conducting outreach to encourage conservation to avoid SWRCB fines.

While Mr. Townsley testified that extensive public outreach was necessary because "[t]he community needed to understand the issues being faced in regards to water supply" the Commission has already found that Monterey customers are well aware

¹ Cal Am claims that there was a need to familiarize the public with desalination technology. (Cal Am Brief, p. 22.) Cal Am has not demonstrated why this education was necessary.

of the water supply issues surrounding their community and further education on this issue is unnecessary. (Cal Am Opening Brief, p. 23 citing Exhibit 7, p. 6; Re California-American Water, (1990) 38 CPUC 2d 15, 27 (D.90-10-036).) Cal Am's outreach campaign for the Coastal Water Project, of \$35 dollars per customer, is excessive. Such an expensive outreach program is unnecessary and not supported by past Commission decisions authorizing conservation spending.

B. Cal Am's reliance on Hillview Decision is misplaced

Cal Am argues in its Opening Brief that surcharges 1 and 2 are consistent with Commission precedent, citing D.02-11-015 issued in the I.97-07-018, the Investigation of Hillview Water Company ("Hillview"). As Monterey Peninsula Water Management District ("MPWMD") argued in its Opening Brief, D.02-11-015 involved Hillview, a small, troubled, class C water company that was seeking Commission authorization to enter into a loan agreement with the Department of Water Resources to borrow money under the Safe Drinking Water State Revolving Fund ("SDWSRF"). (Investigation of Hillview, (D.02-11-015), pp. 1-2.)² Hillview was to use the money from the loan for system improvements required to comply with Department of Health Services safe drinking standards (Id. at p. 2.) .

The Hillview case involved a company that was not in compliance with state drinking water standards and needed capital to comply with the requirements. The Department of Health Services approved a \$3.4 million loan for Hillview at zero-percent interest to provide Hillview with the capital needed for the required improvements. The Department of Health Services required Hillview to implement a surcharge to cover the loan debt and reserve requirements as part of the SDWSRF loan agreement. (Id. at, p. 8.)

As the Commission rightfully pointed out, Hillview would not have been able to obtain the SDWSRF loan unless it could demonstrate to the Department of Health

² Hillview's loan application was consolidated with a Commission investigation of Hillview regarding possible violations of statutes and regulations in connection with, among other things, the utility's investment in plant

Services that it had secured a source of funds to be used to repay the loan. (*Id.* at pp. 19-20.) Without the low-cost funding provided by the SDWSRF loan, Hillview would not have been able provide adequate, safe and potable water. (*Id.* at p. 20.) Thus the Commission had to grant Hillview the surcharge request to assure that it could comply with safe drinking water standards. However, while the surcharge was authorized prior to the plant being placed into service, the surcharge was not *implemented* until the completion of construction.³

Cal Am's situation is not similar to Hillview. Cal Am is not experiencing the type of financial difficulty that requires the special treatment afforded Hillview. No prospective loans are contingent on the Commission granting Cal Am its surcharge requests. While the State Water Resources Control Board has issued an order finding that Cal Am does not have the legal right to take 10,730 acre feet from the Carmel River, it has not issued any deadline for compliance. Cal Am is not violating any DHS requirement and is providing customers with safe, potable water.

Cal Am argues that without the surcharges the Coastal Water Project may create "perceived risk" on the part of investors." (Cal Am Opening Brief, p. 12.) However, the Commission has previously found that lower financial ratings were not sufficient to demonstrate a need to depart from traditional ratemaking. (*Re Southern California Edison*, D.05-12-040, p. 54.)

The extraordinary cost of the project coupled with the small number of ratepayers that will pay for the project is the justification for a limited departure from the "used and useful" ratemaking principle. As DRA discusses in its Opening Brief, the Commission should act cautiously when departing from traditional ratemaking practices. The

³ "Hillview is authorized to file in accordance with General Order No. 96-A, and make effective on five days' notice, but not earlier than 30 days prior to completion date of the project as verified by the state Department of Health Services, an advice letter which implements the rate surcharges to customers of the Oakhurst and Sierra Lakes districts attached to this order as Appendices A and B." D.02-11-015, Ordering Paragraph 2.

Commission should require that there be more certainty regarding the final project before any surcharge is implemented. The Commission must also establish safeguards to protect ratepayers, as departing from traditional ratemaking practices shifts certain risks to the ratepayers. DRA refers to its Opening Brief for further discussion of its proposal and the safeguards the Commission should adopt. (DRA Opening Brief, pp. 31-40.)

C. Cal Am's reliance on the C  nada Reservoir case is misplaced

Cal Am claims that surcharge 1 is consistent with Commission precedent, citing D.90-10-036 issued in the California-America Water Company Application 89-11-036. In D.90-10-036, the Commission allowed Cal Am to recover \$1.5 million in costs incurred on feasibility studies undertaken at the direction of the Commission on the C  nada Offstream Storage Reservoir Project. (Re California-America Water Company, (1990) 38 CPUC 2d 15, 26.) In allowing Cal Am to amortize these costs over a five year period, the Commission stated that the company could only earn interest on the unamortized amount at the fixed rate of the average 90-day commercial paper rate for the first 6-months of 1990.⁴

As MPWMD points out in its Opening Brief, the recovery allowed was for a modest sum and did not include a request to recover future costs. (MPWMD Opening Brief, p. 8.) In this case, Cal Am's request is a substantial sum that continues to escalate and many of its costs have not been reviewed for reasonableness. (Id. at p. 9.) While here Cal Am is seeking to earn its authorized rate of return on all preconstruction costs, D.90-10-035 specifically found that Cal Am should not earn its authorized rate of return on prudently incurred feasibility study costs. Instead the Commission found that Cal Am should earn only a fixed rate on the unamortized expenses based on the 90-day commercial paper rate. Decision 90-10-035 does not support Cal Am's surcharge 1 request.

⁴ DRA proposes to allow Cal Am to earn interest on the unamortized balance of all prudently incurred costs at the 90-day commercial paper rate. As the 90-day commercial paper rate changes, so to would the
(continued on next page)

D. Cal Am's reliance on the Water Action Plan to support immediate implementation of the proposed surcharges is misplaced

The purpose of the Commission's Water Action Plan is to identify the policy objectives that will guide the Commission in regulating investor-owned water utilities. (Water Action Plan, p. 3.) The Water Action Plan highlights actions that the Commission anticipates it may take or actions it may consider to implement these objectives. (*Id.*) Cal Am's reliance on this Plan as justification for its proposal and its claim that any decision on its interim rate request must be consistent with the Water Action Plan is misplaced.

The Water Action Plan is simply a plan, nothing more. How the objectives set forth in the plan will be achieved was not determined at the time the Water Action Plan was issued. The potential actions that are set forth in the plan are simply proposals that were not litigated or thoroughly vetted through a formal proceeding. There is nothing in the Water Action Plan that requires the Commission to adopt a proposal just because it is included in the plan as an item for the Commission to consider as one of the ways to meet its overall objectives.

Cal Am states that both of its proposed surcharges are similar to the Water Action Plan's suggestion to consider allowing pass-through of valid development charges prior to plant start-up. (Water Action Plan, p. 22.). This item in the Water Action Plan states:

5. Allow valid development costs to be recovered as they occur.

Similarly, certain valid development costs incurred prior to actual plant start-up, such as environmental compliance costs and engineering costs, can be passed-through to ratepayers as they occur, rather than deferring the charges until actual plant start-up, which ratepayers may find more difficult to pay as a much larger one-time charge. This "prepay account" would reduce the "carrying cost" of the plant, thereby reducing the overall cost of the plant. (Water Action Plan, p. 22.)

(continued from previous page)
rate Cal Am is authorized to earn.

Thus this action item does not include a proposal to allow development costs to be recovered before a major plant is even permitted. Moreover the Water Action Plan does not propose authorizing the recovery of preliminary costs before a reasonableness review has been completed or before some of the expenses have even been incurred. Moreover, it says absolutely nothing about requiring ratepayers to contribute capital to fund utility plant at any time.

Rather than supporting Cal Am's proposal, this Water Action Plan objective is much more in line with DRA's compromise position to allow recovery of already incurred preconstruction costs that have been reviewed for reasonableness and authorized for recovery by the Commission. DRA agrees that in certain cases, such as the Coastal Water Project where the capital cost is extremely high, it may make sense to consider expensing development costs prior to plant start-up (rather than waiting and capitalizing those costs at plant start-up) to reduce overall plant costs. However, the point is that the Commission wished to consider the merits of the Water Action Plan in specific proceedings. This proceeding affords that opportunity. The Water Action plan did not predetermine the outcome of any given proceeding.

The above Water Action Plan action item applies only to the proposal and discussion of Cal Am's proposed surcharge 1. This item is a deviation from traditional ratemaking as stated above, and DRA urges the Commission to authorize use of such a mechanism on a case by case basis and only for utility plant that has already received a CPCN, and then only for already incurred preconstruction costs that have been reviewed for reasonableness. Cal Am's reliance on the Water Action Plan as justification for its surcharges is misplaced.

IV. PRECONSTRUCTION COSTS

A. Cal Am has not demonstrated that all 2005 preconstruction costs are reasonable

Cal Am argues that it should be allowed to begin surcharge 1 now because it has demonstrated that preconstruction costs incurred through 2005 are reasonable and prudent. (Cal Am Opening Brief, p. 20.) Cal Am supports this claim by arguing that it did its own “line-by-line review” of preconstruction costs in April 2006 (after it had already requested recovery of what it claimed were reasonably incurred preconstruction costs) and reduced its previous request by \$557,781. However, Cal Am’s “line-by-line” review of what was already suppose to be prudently incurred costs, still did not remove all costs that should be disallowed by the Commission.

Mr. Tilden testified that costs associated with a trip to Sacramento to brief Assemblyman John Laird probably should have been removed from the recovery request, but were not. (Cal Am/Tilden, 7 RT 717.) Mr. Tilden testified that Cal Am failed to remove from its recovery request travel costs associated with meetings costs that were removed. (Cal Am/Tilden, 7 RT 738; Exhibit 62, p. 486.) It also appears that Cal Am is requesting recovery of costs associated with the San Clemente Dam Project⁵ as part of the Coastal Water Project. (MPWMD Opening Brief, pp. 19-20; Exhibit 62, pp. 511, 518, 527.) Moreover, Mr. Tilden testified that at the time he was reviewing the invoices for the line-by-line post filing review, he did not try to figure out what the expenses were for. (Cal Am/Tilden, 7 RT 718.) Thus it is not clear how Cal Am decided to remove some costs and not other identically identified costs. (For example, see costs identified as “AB2918 & AB3039” in Exhibit 49, p. 3.)

Cal Am apparently believes that because it voluntarily reduced its preconstruction cost request by \$557,781 that DRA should not question its request for the remaining

⁵ The San Clemente Dam is a concrete arch dam constructed in 1921 and operated by Cal Am. The reservoir has not been dredged and thus excessive amounts of sediment have accumulated removing 90 percent of its storage capacity. The dam is seismically unsafe. Cal Am is considering whether to retrofit the dam, remove the dam, or divert water around the dam to address the safety issue.

expenses. DRA disagrees. Cal Am's request still contains costs that should not be paid for by ratepayers. However, DRA's proposal to reduce allowable public outreach costs to \$160,000 will remove these costs and other excessive and unnecessary expenditures that should not be born by ratepayers.

B. DRA's proposed disallowance of public outreach costs is not arbitrary and is supported by the record

DRA discussed Cal Am's public outreach campaign in detail in its Opening Brief and will not reargue those issues here. (See DRA Opening Brief, pp. 18-31.) DRA's Opening Brief refutes Cal Am's claim that DRA did not provide justification for its reduction of Cal Am's outreach program to \$160,000. DRA here responds to new issues raised by Cal Am.

Cal Am argues that DRA's allowance of \$160,000 for public outreach is arbitrary and meaningless. (Cal Am Opening Brief, p. 24.) Cal Am argues that the Commission should allow Cal Am to recover all of its requested public outreach costs because DRA did not describe how the \$160,000 it would allow for public outreach should have been spent, stating that DRA did not provide estimates for how many meetings, mailing or newspaper notices Cal Am should have had and did not discuss whether DRA's proposed budget included website costs. (*Id.*)

Cal Am is apparently arguing that it was DRA's responsibility to create a detailed outreach plan to support its proposed disallowance. DRA has no such responsibility, Cal Am does. As demonstrated in its Opening Brief, Cal Am did not even create such a document to support its own outreach program. (DRA Opening Brief, p. 22-24.) DRA provided sufficient justification to support its recommended disallowance. DRA demonstrated that Cal Am had excessive spending, employed deficient contracting practices, and failed to adequately measure the success or failure of its campaign. (*Id.* at pp. 18-31.) Moreover, DRA demonstrated that its proposal to allow Cal Am to recover \$4.25 per customer was in-line with other comparable outreach campaigns, including a more controversial program to convince customers to overcome their aversion to drinking

reclaimed wastewater. (*Id.* pp. 21-22.) DRA's proposed disallowance is fully supported by the record.

Cal Am also argues that DRA's criticisms of Cal Am's outreach campaign are contradictory, stating that while DRA claims its campaign was excessive, it also suggests that additional outreach on rate impacts was necessary. DRA criticisms are not contradictory.

Cal Am spent time and money educating Monterey residents about the community's water supply problems, an area the Commission has already stated that ratepayers are well aware of and that requires no further education.⁶ (*Re California-American Water*, (1990) 38 CPUC 2d 15, 27.) Cal Am also spent significant amounts on educating Monterey residents about desalination technology and the permitting process through community meetings, an expensive process that reached an unknown number of people. Cal Am spent a disproportionate percentage of its public outreach campaign trying to educate ratepayers about the all too familiar water supply problems and details of desalination technology, in comparison to the educating customers about the most important aspect of the project -- how it would affect their water rates and monthly water bill.

With a budget and clear goals, Cal Am could have conducted a more focused outreach campaign through less expensive means such as bill inserts -- a method the Commission previously supported for conveying information to customers about prior water supply projects -- and other less expensive strategies. (*Id.*) Clearly Cal Am can run successful campaigns for less. For example, Cal Am spent \$300,000 to defeat Measure W, the most ever spent on a political campaign on the Monterey Peninsula. (Exhibit 18, pp 25-25.) Cal Am has done nothing to explain why it needed to spend over four times this amount to educate consumers about its proposed desalination plant.

⁶ See for example Exhibit 39 which contains

C. DRA has demonstrated that an expert is needed to review preconstruction costs for reasonableness

Cal Am argues that there is no need for anyone to review already incurred engineering and environmental preconstruction costs for reasonableness. (Cal Am Opening Brief, pp. 27-28.) Cal Am claims that these costs are routine costs or are the type of costs that a person familiar with water supply or water treatment projects could review for reasonableness. (Id. p. 27.) DRA disagrees.

Cal Am's witness Mr. Gallery testified that certain expertise is necessary for this project that differs from traditional water supply or treatment projects. Mr. Gallery testified that an ASR system requires specific expertise on the characteristics of injecting water into a well and hydrogeology characteristics that differs from the expertise required for a regular well project. (Cal Am/Gallery, 7 RT 793.)

Cal Am argues that it should be allowed to recover 2005 preconstruction costs because some of these costs were spent on studies and other work that can be characterized as used and useful. (Cal Am Opening Brief, p. 10.) Just because a study was preformed and possibly used for another part of the project does not make that initial study prudent if it was duplicative of a study done by another agency and thus could have been avoided. Cal Am preconstruction expenses cannot be looked at in a vacuum. Several other desalination and ASR projects are being worked on by agencies. Other agencies and companies have already completed technical studies applicable to the Coastal Water Project. (Cal Am/Gallery, 7 RT 798.) A review of Cal Am's preconstruction expenditures must consider whether these costs could have been avoided to determine if they were reasonable.

Specifically, Mr. Gallery testified that RBF reviewed many of these studies including:

- Technical studies preformed by Duke on the desalination site
- Plans, profiles, and other studies on the Duke's cooling system
- Sand City studies on its desalination facilities
- MPWMD studies on its desalination facility ASR project. (Id.)

However, RBF documents state that while it intended to review these and other technical studies, the intent of its Phase I effort was “to produce independent stand-alone technical studies to support the Coastal Water Project preliminary design, community outreach and environmental/permitting process.” (Exhibit 65, Ex. A, p. 7.) It appears that studies may have been performed unnecessarily; however, DRA does not have the expertise to make this determination.

Someone with expertise in the areas of ASR and desalination must review these studies and other costs to determine whether the costs were unnecessary and whether Cal Am could have and should have relied on existing studies and avoided duplicating certain costs. DRA has retained a consultant to assist with the Phase II review of the Coastal Water Project. This consultant can perform such a review of the engineering and environmental preconstruction costs. DRA recommends that the Commission order Cal Am to reimburse the Commission for the cost of hiring this consultant to review already incurred and future preconstruction costs.

D. DRA does not oppose Cal Am’s proposal for future reasonableness review of preconstruction costs if several changes are made to the proposal

In response to the ALJ’s request, Cal Am presents a plan to review preconstruction costs beyond 2005 for reasonableness. Cal Am proposes to have DRA and its expert, if necessary, review preconstruction costs on an annual basis and issue a report on its review within six months of receiving the cost data from Cal Am. Under Cal Am’s proposal, DRA would determine the amount of preconstruction costs the Commission should and should not allow Cal Am to recover through surcharge 1. Cal Am would separately track those costs that DRA and its expert determine Cal Am should not be allowed to recover. Once construction begins, the Commission would schedule testimony and hearings to review all preconstruction costs since 2005. All parties could make a showing as to whether the Commission should allow recovery of the preconstruction costs. Once the Commission decides on the amount of recovery it will

authorize, Cal Am would adjust the amount authorized for recovery as necessary. (Cal Am Opening Brief, p. 29.)

If the Commission wants to adopt the process proposed by Cal Am rather than the annual review process DRA proposed in its Opening Brief, DRA proposes four changes to Cal Am's proposal. First, the Commission should allow other parties to review Cal Am's costs at the same time as DRA's review. Costs that other parties claim are unreasonable or imprudent should be separately tracked with those costs identified as such by DRA.

Second, the Commission should not allow Cal Am implement a surcharge to collect preconstruction costs until the project has received a CPCN from the Commission. Cal Am can still track the costs as proposed so that if or when a CPCN is granted, recovery of the unchallenged costs can immediately begin.

Third, Cal Am's proposal should be modified to include a review of 2005 preconstruction costs for reasonableness by DRA's expert. Cal Am is requesting recovery of \$8,663,334 in preconstruction costs through 2005. Of this, \$5,670,073 is for engineering and environmental costs; \$1,353,831 is for public outreach, and \$1,639,429 is for project management, legal, administrative, and other costs.

DRA recommends that the \$5,670,073 in engineering and environmental costs be set aside and tracked separately until DRA's consultants have been able to evaluate these costs for potential duplication and reasonableness. The Commission should disallow \$1,193,831 of the requested \$1,353,831 in public outreach costs as unreasonable as this issue has been litigated in this proceeding. The Commission should find the remaining \$160,000 of public outreach costs reasonable. The Commission should also approve recovery of \$1,639,429 in other cost. Once the Commission has issued a CPCN for the Coastal Water Project or alternative, the Commission should allow Cal Am to begin a surcharge to recover the \$1,799,429 in approved costs.

DRA proposes to review engineering and environmental costs incurred through 2005 with its review of 2006 costs. DRA would make further recommendations on what portion of these costs the Commission should allow Cal Am to recover once a CPCN is

issued for the Coastal Water Project or alternative and what costs the Commission should disallow. Once reviewed, these costs could be tracked in the same manner as the 2006 and 2007 preconstruction costs.

Fourth, consistent with Decision 03-09-022, Cal Am should continue to earn interest on these costs at the 90-day commercial paper rate. (Re California-American Water Company, D.03-09-022, p. 22.)

Finally, in its testimony, DRA has recommended that Cal Am be authorized recovery of only 50 percent of the approved costs until the plant is placed into service. (Exhibit 18, pp. 19-20.) Because DRA has not recommended a disallowance of the engineering and environmental costs, but merely a temporary setting-aside of these costs pending further review, DRA recommends that once the Coastal Water Project or other long term water supply project is permitted, the Commission allow the Cal Am to recover the full \$1,799,429 in surcharge 1.

However, if the Commission rejects DRA's recommendation about the timing of the surcharge, and decides instead to allow recovery immediately, DRA recommends that the Commission limit recovery of preconstruction costs to 50 percent of approved preconstruction costs to limit ratepayer exposure to risk of the project being abandoned or not completed in a timely fashion.

V. OTHER ISSUES

A. Monterey County Health Code Section 10.72.030 makes the final outcome of the Coastal Water Project uncertain

Cal Am claims that Monterey County Health Code Section 10.72.030, which requires that desalination plants be publicly owned and operated, does not make the Coastal Water Project uncertain, thus justifying delaying implementation of the two proposed surcharges. DRA disagrees.

Cal Am argues that there are three likely outcomes regarding this ordinance 1) a public/private partnership will develop; 2) Monterey County will rescind the ordinance, or 3) Cal Am will challenge the ordinance in court. (Cal Am Opening Brief, p. 35.) DRA addresses these outcomes.

The first possible outcome Cal Am forecasts to claim that delaying the surcharge proposals is unnecessary is that a public/private partnership will develop. DRA agrees that this is a possible outcome. However, as DRA stated in its Opening Brief, how ratepayers may pay for the Coastal Water Project is likely to differ substantially if it is publicly owned and operated. A publicly owned plant may be funded through bonds rather than through rates. Up until the time of the Opening Brief, Cal Am had not addressed what it proposes to do with funds already collected if its surcharge was implemented now and the project eventually becomes a publicly owned plant.⁷ This is a significant issue that should be determined before the Commission permits Cal Am to pre-collect funds for a project that is not even permitted and certainly justifies not implementing the surcharge until the Coastal Water Project or other long-term water supply solution is permitted and more certain.⁸

The second possible outcome Cal Am cites regarding Monterey County Health Code Section 10.72.030 is that Monterey County will rescind the ordinance. However, as both Cal Am President Mr. Townsley and Mr. Feizollahi testified, they were not aware of any action under way by the County to change this ordinance. (Cal Am/Townsley, 3 RT 188; Cal Am/Feizollahi, 2 RT 101.) Moreover, Mr. Townsley testified that to his knowledge Cal Am is not conducting any lobbying to change the ordinance. (Cal Am/Townsley, 3 RT 188.)

The third possible outcome Cal Am cites regarding Monterey County Health Code Section 10.72.030 is that Cal Am will challenge the ordinance in court. Although Cal Am argues that state law preempts the ordinance, there is no need for DRA or the Commission to determine that issue here to demonstrate the effect the ordinance may

⁷ Cal Am's opening brief contains a single sentence on this issue, stating that that "funds could be applied to purchased water costs." (Cal Am Brief, p. 3.) DRA addresses this proposal in section VI.B below.

⁸ DRA recommends that the Commission limit the use of funds from this account to offsetting the future capital costs of any long-term water supply solution that is ultimately approved, or be refunded to ratepayers if something changes and a new plant is no longer necessary. (Exhibit 18, p. 30.)

have on the project.² A legal challenge to the ordinance would take years to complete. Cal Am had not filed a lawsuit and Mr. Feizollahi testified that Cal Am has no plans to take any legal action to challenge this ordinance. (Cal Am/Feizollahi, 2 RT 102.) Thus this possible scenario will not be resolved in the near future.

B. Cal Am’s suggestion to use surcharge 2 funds for purchased water costs if the Coastal Water Project becomes publicly owned further supports DRA’s position that the surcharge should not begin until the project is permitted and construction has begun

In its Opening Brief, Cal Am for the first time provides a proposal on what it thinks should happen to funds collected under surcharge 2 if the Coastal Water Project ends up being publicly owned and operated. Cal Am states that funds collected under surcharge 2 could be applied to purchased water costs. (Cal Am Opening Brief, p. 3.) Cal Am apparently believes that it is appropriate to use funds that were intended to be used as a contribution to offset the capital costs of the Coastal Water Project and permanently reduce future costs to ratepayers to be used to pay for expenses.

DRA opposes Cal Am’s suggestion to use surcharge 2 funds to reduce expenses if the Coastal Water project, or alternative, is publicly owned. The purpose of surcharge 2 is to permanently reduce the costs of the Coastal Water Project, or alternative, for the ratepayers. Using these funds to merely reduce expenses provides no long-term benefit to ratepayers.

² DRA has not researched whether or not the ordinance is preempted but notes that Cal Am has not cited any state law that expressly preempts this ordinance. Although Cal Am claims that the Cobey-Porter Saline Water Conservation Law “expressly recognizes that the private sector can and should be involved in desalination, when it stated that the department [of Water Resources] either independently or in cooperation with any county, state, federal, or public or private agency or corporate may conduct a program of investigation, study and evaluation in the field of saline water conservation” that language refers only to the investigation, study, and evaluation of saline water conversion and does not discuss the ownership and operation of desalination facilities. (Cal Am Brief, p 34, citing Cal. Water Code § 12948.) Water Code § 12949 states that after the Department of Water Resources submits a written report and obtains authorization by the Legislature, the Department may independently, or in cooperation with other public or private agencies, finance, construct, and operate a saline water conversion facility.

Raising this proposal at such a late point only further demonstrates that Cal Am's proposal to implement surcharge 2 before the project is even permitted or construction has begun is not appropriate and has not been thoroughly developed by Cal Am on the record. The Commission should not authorize Cal Am to start collecting funds now for a project that may never be built, owned, or operated by Cal Am. The Commission should allow surcharge 2 to begin only after the project is more certain and the Coastal Water Project, or an alternative, is permitted and construction begins, subject to the safeguards outlined in DRA's report and Opening Brief.

VI. CONCLUSION

For all of the foregoing reasons, and for the reasons set-forth in its testimony and Opening Brief, DRA recommends that the Commission adopt its recommendations regarding special request surcharges 1 and 2.

Specifically, DRA recommends the Commission allow Cal Am to implement a surcharge to recover preconstruction costs after the Commission has issued a CPCN for the project and after preconstruction costs have been reviewed for reasonableness. Specifically, DRA recommends the Commission defer approving recovery of the engineering and environmental preconstruction costs incurred through 2005 and authorize DRA to hire a contractor under a reimbursable contract to review these costs and 2006 and 2007 preconstruction costs. DRA recommends the Commission disallow \$1.2 million in public outreach and administration costs incurred through 2005 as unreasonable and unnecessary.

To prevent rateshock, DRA recommends that the Commission authorize Cal Am to implement a limited surcharge, with safeguards, to fund the Coastal Water Project, or alternative, that would begin after the Commission has approved the project and after construction on the project has begun. Revenue generated from the surcharge should be treated as a contribution to off-set the cost of the Coastal Water Project or alternative. The Commission should limit the amount that ratepayers will contribute to 10 percent of Cal Am's authorized revenue requirement for the year. The customer contribution to the

Coastal Water Project should be permanently excluded from ratebase to protect ratepayers.

Because of inequities in Cal Am's rate design which result in customers being charged vastly different amounts for the same water usage, DRA recommends that both surcharges be structured as volumetric charges on each unit of water. With a volumetric surcharge everyone that uses the same amount of water will pay the same surcharge. DRA also recommends that ratepayers participating in Cal Am's low-income program pay half of any surcharge the Commission authorizes.

Respectfully submitted,

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September 22, 2006

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of “**REPLY BRIEF OF THE DIVISION OF RATEPAYER ADVOCATES ON CALIFORNIA AMERICAN WATER COMPANY’S REQUEST FOR INTERIM RATE RELIEF**” in **A.04-09-019**, by using the following service:

☒ **E-Mail Service:** sending the entire document as an attachment to an e-mail message to all known parties of record to this proceeding who provided electronic mail addresses.

☐ **U.S. Mail Service:** mailing by first-class mail with postage prepaid to all known parties of record who did not provide electronic mail addresses.

Executed on **September 22, 2006** at San Francisco, California.

/s/ ALBERT HILL

Albert Hill

N O T I C E

Parties should notify the Process Office, Public Utilities Commission, 505 Van Ness Avenue, Room 2000, San Francisco, CA 94102, of any change of address and/or e-mail address to insure that they continue to receive documents. You must indicate the proceeding number on the service list on which your name appears.

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